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California Public Employees' Retirement System

Summary of Program Changes for the Investment Office Incentive Plan

*Presentation to the Performance and Compensation Committee
of the Board of Administration*

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San Francisco

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Seattle

Agenda

Item	Topic
1	Review : Proposed changes to CalPERS Investment Office (“INVO”) incentive plan design and policy
2	Discuss : Proposed changes to <ul style="list-style-type: none">• Incentive schedule• Performance plan weightings
3	Review : Additional program changes for future consideration
4	Review : Next steps for implementation
5	Discuss : Critical Retention Issue

Review: Proposed Changes to the INVO Incentive Plan Design

Board Expressed Area of Concern	Proposed Change
Board Discretion	<ul style="list-style-type: none"> • Board directed staff to draft language that would allow awards to be deferred, modified or eliminated if the Total Fund one year return is negative.
Design should be transparent and consistently applied across CalPERS	<ul style="list-style-type: none"> • Single total fund measurement period – rolling three-years • Consistent total fund component across levels (SIO, SPM and PM) • Working toward roll-up of individual portfolios into one composite portfolio for the individual component
Incentive compensation plan design should be aligned to CalPERS program goals	<ul style="list-style-type: none"> • Increased Alpha target for Global Equity portfolio minimum incentive compensation point and Total Fund • The investment benchmarks used for incentive compensation will be the same as for investment performance measurement with exception of AIM portfolio¹

¹ The strategic benchmark for AIM does not match the private investment opportunities that the staff faces; therefore, it is not a preferred benchmark for purposes of incentive compensation

1

Review: Proposed Changes to the INVO Incentive Plan Policy

Proposed Change	Summary Description
Goal Setting	<ul style="list-style-type: none">• Performance plans are set and approved by Board by start of the fiscal year
Action upon violation of or non-compliance with policy	<ul style="list-style-type: none">• Allows the board recourse in situations where an employee has violated policy and earned incentives, but is no longer with the organization when the violation is discovered
Action upon unsatisfactory individual performance	<ul style="list-style-type: none">• If individual performance rating is 'Does Not Fully Meet Standards' employee is ineligible to receive any portion of the incentive compensation award
Action upon voluntary separation	<ul style="list-style-type: none">• Employee must be employed by CalPERS on the payment date to receive an award, except in the case of death, disability or retirement

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Discuss: Proposed Changes to the Incentive Schedule

Total Fund (assumes rolling three-year measurement period and current strategic asset allocation targets)

- Increase Minimum, Target, and Maximum incentive schedule
- Incentive schedule is based on an active risk budget of 1.9% (versus historic averages of 2.5%)

Asset Class (assumes rolling three-year measurement period and current strategic asset allocation targets)

- Increase Global Equity minimum to 0 (Global Equity is primarily a passively managed portfolio – minimal alpha expectation; will receive performance credit for securities lending income)
- Reduce Global Fixed Income implementation ranges and key risk factors by 50%

Current Incentive Schedule			
	Minimum	Target	Maximum
	0	1.0	1.5
Asset Class			
Global Equity	- 50 bps	- 10 bps	+ 15 bps
Global Fixed Income	0 bps	+ 40 bps	+ 60 bps
Real Estate	0 bps	+ 30 bps	+ 45 bps
AIM	50 th Percentile	40 th Percentile	30 th Percentile
ILAC	0 bps	+ 30 bps	+ 50 bps
Total Fund	- 40 bps	0 bps	+ 20 bps

Proposed Incentive Schedule			
	Minimum	Target	Maximum
	0	1.0	1.5
Asset Class			
Global Equity	0 bps	+ 10 bps	+ 15 bps
Global Fixed Income	0 bps	+ 20 bps	+ 30 bps
Real Estate	0 bps	+ 30 bps	+ 45 bps
AIM	50 th Percentile	35 th Percentile	25 th Percentile
ILAC	0 bps	+ 30 bps	+ 45 bps
Total Fund	0 bps	+ 20 bps	+ 30 bps

Cost adjust benchmarks, where appropriate, for passive portfolios

2

Discuss: Proposed Changes to the Performance Plan Weightings

- Multi-year history of increasing the Total Fund weighting
- Proposed weighting shown are management's recommendation to the Board, which Mercer supports. This proposal:
 - Focuses on Total Fund through both quantitative and qualitative measures.
 - Allows Total Fund quantitative measures to be applied consistently across INVO.
 - Reflects primary areas of focus for different levels:
 - CIO – Total Fund
 - SIO – Total Fund / Asset Class
 - SPM – Asset Class / Portfolio / Total Fund
 - PM – Portfolio / Asset Class
- Ranges within the Portfolio and Qualitative areas reflect the fact that responsibilities are not identical across level (some SPMs manage portfolios, while other do not)
- Some specialized job families will have customized weightings given the nature of the role (corporate governance, asset allocation/risk, operations)

Timeline of Changes to Total Fund Weighting

Level	2007 - 8	2008 - 9	2009 - 10	Proposed 2010 - 11
CIO	40%	40% ¹	40%	70%
SIO	25%	25%	40%	40%
SPM	10%	10%	25%	20%
PM	0%	0%	10%	10%

¹Reflects the Total Fund weighting used in 07-08; the actual 08-09 weighting was modified to accommodate an Interim CIO appointment

Proposed 2010 - 2011 Performance Plan Weightings

Level	Quantitative			Qualitative
	Total Fund	Asset Class	Portfolio	
CIO	70%	-	-	30%
SIO	40%	35% to 45%	-	15% to 25%
SPM	20%	30%	10% to 30%	15% to 25%
PM	10%	25%	10% to 50%	15% to 35%

3

Review: Additional Program Enhancements for Future Consideration

- Following asset allocation study and risk budget implementation, we recommend further integration of the incentive compensation program:
 - Use of forward looking risk budgets that will allow adjustment of incentive targets based on anticipated and realized risk
 - Reevaluate benchmarks for alignment with strategic asset allocation
- Consider assigning probabilities for incentive points (minimum, target and maximum)
 - Promotes consistency among asset classes
- Adjust incentive compensation points for the measurement period
- Consider modifying incentive schedule to include more than the current three points

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Review: Next Steps of Implementation

1. Measurement Period:
 - Finalize asset class and portfolio measurement periods: rolling 3-year versus 1-, 3- and 5-years (requires impact analysis at asset class, portfolio and individual levels)
2. Performance Plans:
 - Finalize performance plans for August Board meeting based on recommended incentive schedule and weightings

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Discuss: Critical Retention Issue

Situation:

Underperformance of real estate portfolio will likely prevent any incentive earnings under the Total Fund component for the next several years. Management is concerned that this will affect staff retention and motivation in the near-term.

Recommendation:

Mercer considers this a business issue and recommends the Board assess the need for a retention program designed to retain top performing staff who add significant value to the organization.

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